DOW THEORY LETTERS INC.

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THE MARKET: Here's an interesting project for a rainy Sunday. Curl up in your easy chair with the charted history of the Averages, and study all the advances of the past 40 or 50 years. If you find this sort of work to your taste, you'll discover a variety of fascinating facts. And one of the things you'll discover is that very few major advances "top out" without producing at least hints of impending danger in the price structure. If there is going to be trouble ahead there will usually be a major non-confirmation, a series of non-confirmations, a period of divergence (i. e. one Average advances persistently while the other declines) or an area of "churning" (i. e. high volume with the Averages making little or no progress).

A corollary of the above is that when both Averages are climbing into new high territory, and when the advance is well supported by volume (as is now the case), then the rise is usually destined to continue for a further indeterminate distance. Robert Rhea once noted that the market, like a woman, can change its mind in a week, a day or an hour. And undoubtedly somewhere ahead we will be able to identify the place where Wall Street changes its mind. But as far as Dow's Theory is concerned, with the two indicators now climbing into record high territory, the first cracks in the seams of the advance have yet to show themselves.

Nevertheless, it is obvious that investment sources are becoming increasingly attracted to "bargains" in debt securities while at the same time they are less tempted to purchase blue-chips at prevailing yields of 1 to 3%. We note, in fact, that in the face of explosive action in many secondary and speculative issues, such gilt-edged giants as General Motors, General Foods, Telephone, U. S. Steel, Sears, DuPont, International Paper and Goodyear have been moving sideways for months. Meanwhile, investment eyes focus on the exciting developments in the money markets, developments which last week drove yields on the bellwether 91-day Treasury bills to a record high offering of 4.67%, and which have pushed large N. Y. C. banks to the point where they are offering 4.9% for 91-day certificates of deposit and 5% for 180-day C. D.'s.

How long, asks the market student, can an inflation-spurred stock market run up in the face of rising money rates and the greatest bargains in short-term treasury debt in history? This is really another way of asking the time-honored Wall Street question, "how can I

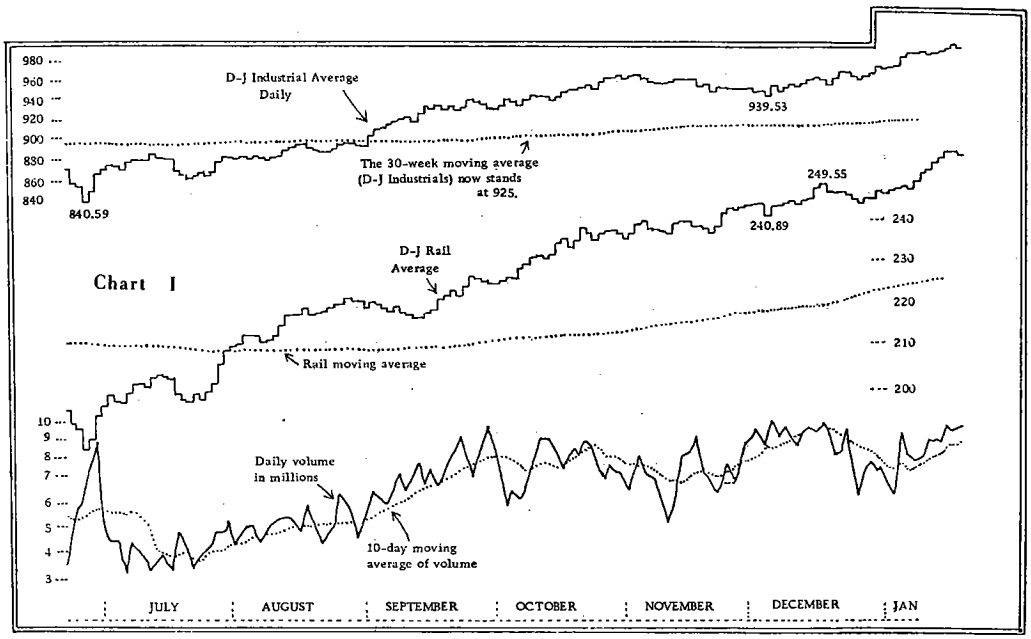
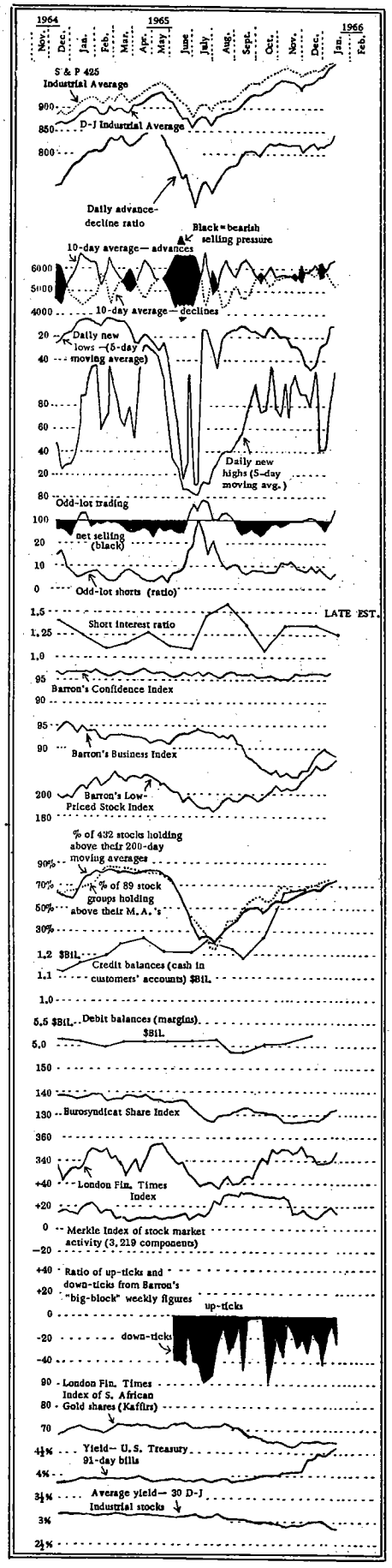
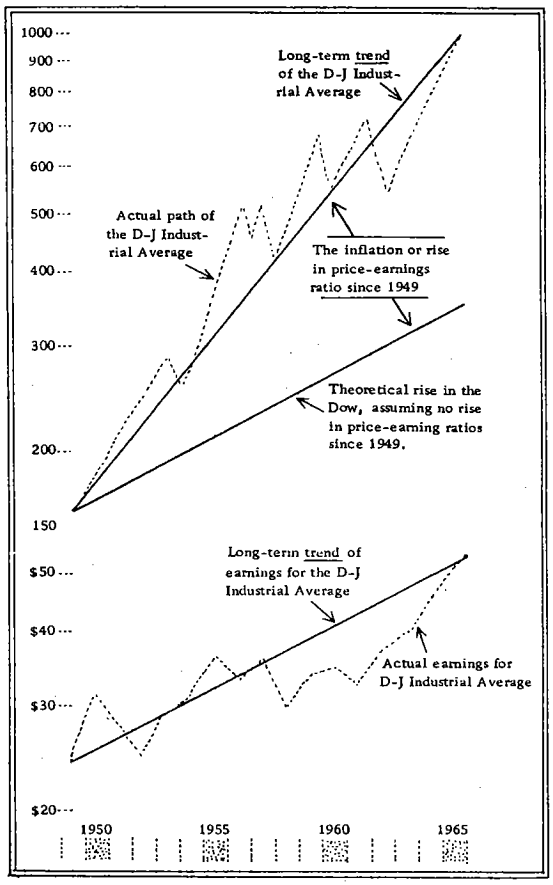


Chart I


1964
1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
LATE EST.
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

pin-point the top?" The answer is that you can't. You must sell stocks in the area where they are discounting "hopes and expectations." In my opinion, stocks are in that area now.



The Composite Chart shows both leading industrial averages at all-time highs. The advance-decline ratio, having bettered its late 1965 high, is now within striking distance of the May, 1965 peak. New highs are checking in bullishly, while new lows are in the 10 area. Odd-lotters are now buying, but there is a seasonal tendency towards buying during the first three weeks in January. The Low-Priced Stock Index is at its highest point since early 1962. The Eurosyndicat Index and the London Index reflect recovery movements in most of the world's exchanges. The negative spread between the yield on the Dow Industrials (2.87%) and the yield on 91-day Treasury bills (4.67%) has now widened dramatically to 1.80, the greatest such margin in favor of bills in history.

Conclusion: To talk about "values" today is to talk about the extraordinary bargains in debt instruments (bonds, bills, notes). To talk about speculating is to talk about the stock market where there are few values but where many stocks are rocketing. Consciously or unconsciously the true investor gravitates toward values.

DYNAMICS OF A BULL MARKET: One of the curious things about a bull market is that the great gains in prices often stem from changes in sentiment (confidence), not changes in earnings. This may come as a shock to most of today's investors, but it is a thesis which is open to simple proof.

I have constructed a chart showing the earnings on the Dow and the trend of the Dow since 1949. The chart has been drawn to semi-logarithmic or ratio scale, and thus percentage of rise can be accurately and correctly compared. The long term trend of price on the Dow runs from 161.60 in June to the current level of just under 1000. The long-term trend of earnings on the Dow runs from the $23.54 of 1949 to approximately $54 for 1965.

One of the advantages of ratio (semi-logarithmic) scale is that it makes for easy comparisons. Thus all parrallel lines drawn on ratio scale show the same rate or the same percentage of advance or decline. Note that above the long-term trend of earnings on the Dow, I have drawn a parallel line, a line which starts from the 161.60 level recorded by the Dow in 1949 (this is where the bull market started). This line portrays the rise which "would have occurred" in the Dow assuming that the Dow had risen at the same rate as earnings since 1949 (in other words, assuming the price/earnings ratios had remained fixed since 1949). It is rather startling to discover as one follows this theoretical rise in the Dow that the Dow would now be selling well under 400.

This means that the "extra yardage" between approximately 375 (the 1965 price based on 1949 price/earnings ratios) and 980 (the actual price today) is due to a steady growth in confidence and an inflation in price/earnings ratios brought on by this rise in confidence. In fact, by far the greatest amount of the rise since 1949 has been due to the rise in price/earnings ratios, not the rise in earnings! For earnings on the Dow have actually increased about 150% since 1949 while the price of the Dow has risen 500%. This would go a long way towards explaining the old Wall Street adage which states that "every bull market is built on two things, credit and confidence." By the same reasoning, the chart suggests what could happen, even assuming that earnings held relatively steady, if the confidence and credit factor began leaving the Wall Street scene.

INFLATION — Question: Isn't inflation running rampant? How do I dare move out of my common stocks and into any sort of protected position in the face of today's galloping inflation?
Answer: There's no questioning the fact that inflation is intensifying. But at this stage of the game, I would rather look upon inflation from the standpoint of timing. Today we are by all odds seeing the tail-end of the great bull market's third phase. Speculation is intense, Wall Street is "where the action is," cocktail parties ring with the names of the current "favorite to double." Yet it is well to remember that this type of market has never lasted very long.

What could bring a halt to the current inflationary trend? Let us examine a few factors. In the face of the rising cost of materials, labor and services we also note that there is a rising trend in every variety of interest rate. When interest rates and inflationary forces clash head on, something has to give. Past history suggests that it is always the forces of inflation. But we should realize that although interest rates are rising, the Federal Reserve Board has sought to offset this by greatly expanding the money supply. This flood of new dollars has splashed into almost every corner of the nation; it has also seeped into the hands of almost every central bank in the world. Foreigners, faced with a rising tide of dollars, have moved to turn these dollars in for gold. The resultant depletion of our gold supply carries with it the seeds of deflation. Why, because the Administration must ultimately move to "defend" the dollar (as the Fed did when they raised the bank rediscount rate in December).

Thus I view the inflation picture not as a long-term problem but as a dramatic short-term tactical problem for investors. It is interesting to report that although the stock market has been discounting a certain amount of inflation ever since World War 11, my own mail now contains more letters regarding inflation than at any time in the past. When everybody recognizes the inflationary forces, and when every shoemaker and candlestick maker is seeking to protect himself against future inflation, we can say that the situation is becoming climactic and probably nearing a turn.

Question: But suppose the gold outflow continues, and suppose some time in 1966 our Administration decides that it wants to go off gold completely? What would prevent them from selling all our gold and then inflating forever?

Answer: The U. S. sets the world price of gold by offering to buy or sell any quantity of gold at $35 per ounce. If the U. S. goes "off gold," this would be tantamount to devaluation. Two things would then occur. As foreigners called in all our gold, we would cease to be a factor in the gold market, and gold would then seek its own natural market level. This might be $60 or $70 per ounce or whatever the market believed was the correct price for gold. Secondly, since gold is still a deterrent to inflation, a U.S. dollar free of legal gold restrictions would lead to considerable inflation of domestic prices. Under such circumstances, the U. S. would have a very difficult time selling its high priced merchandise to foreign buyers. Since the U.S. dollar (without being redeemable into gold) would have no fixed international value, foreigners would not want to sell their merchandise for U. S. dollars. Neither would foreign central banks want to hold unredeemable dollars which might be worth 60¢ next year and 30¢ the following year.

Question: But suppose the U. S. leadership in inflation became the accepted "way of life," and that foreigners also decided to go off gold. Suppose the whole world decides to inflate?

WHAT THEY'RE SAYING: (From the Jan. 15 Issue of E. Geo. Schaefer's "Dow Theory Trader") "For the past year and longer--in fact with each passing week for over a year--the market has been telling us its own interesting story; bond prices are moving downwards, best-quality and highest-grade stocks are no longer attractive to large investment sources, speculation by the public is increasing by leaps and bounds, stocks have entered an area of distribution by investors to the public; as long as confidence and speculation is exciting the public into buying almost anything, our bull market is headed for a final blow-off on the upside, and, finally, even the most speculative issues and the 'cats and dogs' will have their day on the top side in this bubble before it bursts."

(From Money and Credit Reports by Irving Weiss of Capital Advisors) "The new bellwether leader in the money market--where the real action is currently taking place-- is not so much in U. S. Treasury bills as it is in the Certificates of Deposit market. The latest bids of 4.90 for 3-month money and 5% for 6-month money are new highs. Banks bidding for this money are frank to say they are not flushing out much money even at these levels. Result is that privately negotiated deals quietly undercut the public market as C. D.'s are sold at a discount to bring yields as high as 5½%."

(From the Jan. 14 Granville Market Letter) "Regardless of what one may think of Mike Quill, Mayor Lindsay, Governor Rockefeller or what one may read between the lines of the President's State of the Union message, or to what degree one may worry of Vietnam or rising interest rates, the coldly impersonal technical indicators cut through all of that and tell a single undeviating story: they are bullish. If they are bullish, then I am bullish and that is all there is to it."

(From the Jan. 11 Janeway Service) "In the pending confrontation between War Budget dollars and full capacities, something will have to give--unless Johnson can manage to wheel and deal himself out of further escalation. If he can't, our judgment of the political practicalities is that what will give first is the boom-time bear market in bonds; and then the independence enjoyed by the Federal Reserve Board during the inter-war years. This is bound to have serious bearish repercussions - even if de facto money controls are the only new ones coming for a while. Meanwhile, within the Administration, the pressure is on for tax increases; and legislation will be needed and sought to raise the rate of tax withholding. The next immediate step is to form a preliminary guesstimate of the deficit at the new spending level and at present levels of prices, wages and earnings. The new deficit will be a whopper. It will also be a shocker. For it will be the first post-war deficit to aggravate a money squeeze and, therefore, to deflate instead of inflating. If it takes a big surprise to change a trend, the situation is ripe."

(From the Jan. Bank Credit Analyst by Hamilton Bolton) "Events of the last 4 weeks have added little to the hope of a near-end to the deterioration in the credit flows outlook ... All told, we believe continued caution is called for in the equity field.....It is probably a good time for institutional investors to start emphasizing the purchase of long-term high-grade bonds."

(From the Cleveland Trust Co. Business Bulletin) "Nonetheless, the U. S. is still far from having found a formula for perpetual prosperity. Expansion of bank credit year after year in excess of the rate of increase in real output is an inherently inflationary process. And this particular type of monetary policy is not 'new economics,' but 'old economics.' It is, in fact, the very reason the U. S. originally attempted to create a central bank which would be insulated from political pressures."

(Economist Melchior Palyi writing his column from Paris, Jan. 11--Chicago Tribune) "The American tourist interested in Europe's economic and political scenery will be struck by at least two phenomena. One is the apparent irresistible inflationary trend despite more or less earnest efforts to stem it. Price inflation is spreading from one country to another, propelled in most cases by rising wage costs. A second observation should be more surprising; the fact, and it is a fact, that in all European countries, with the exception of Switzerland, public opinion is almost unanimous in blaming us for the Viet Nam war."

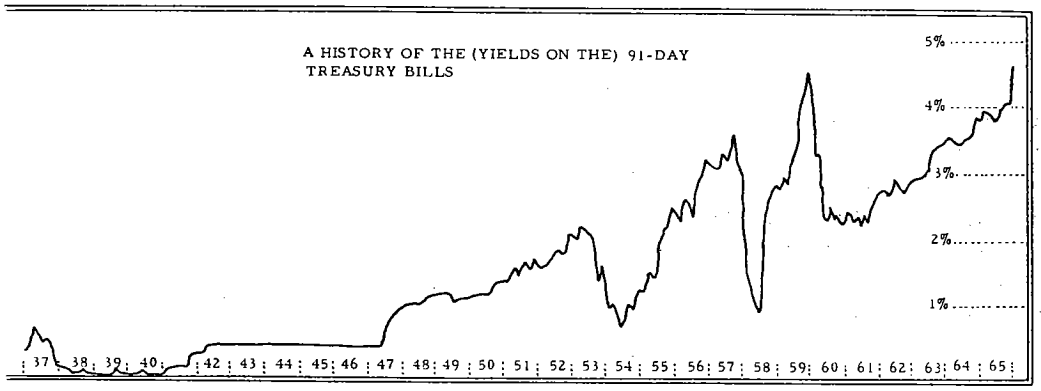
How Nations' Gold Holdings Compare

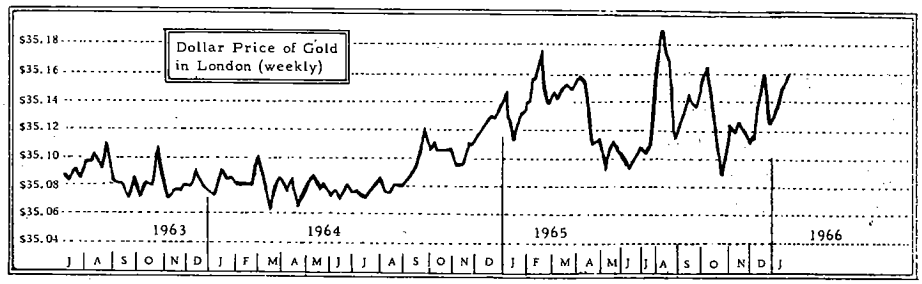
(Millions of Dollars)

	U. S.	Canada	France	W. Germany	Italy	Netherlands	Switzerland	U. K.
1949	$24,563	$ 496	$ 523	——	$ 256	$ 195	$1,504	$1,688
1950	22,820	590	523	——	256	311	1,470	3,300
1951	22,873	850	548	$ 28	333	316	1,452	2,335
1952	23,252	896	573	140	346	544	1,411	1,846
1953	22,091	996	576	326	346	737	1,459	2,518
1954	21,793	1,080	576	626	346	796	1,513	2,762
1955	21,753	1,134	942	920	352	865	1,597	2,120
1956	22,058	1,103	924	1,494	338	844	1,664	2,133
1957	22,857	1,100	581	2,542	452	744	1,706	2,273
1958	20,582	1,078	750	2,639	1,086	1,050	1,925	3,069
1959	19,507	960	1,290	2,637	1,749	1,132	1,934	2,736
1960	17,804	885	1,641	2,971	2,203	1,451	2,185	3,231
1961	16,947	946	2,121	3,664	2,225	1,581	2,560	3,318
1962	16,057	708	2,587	3,679	2,243	1,581	2,667	2,582
1963	15,596	817	3,175	3,843	2,343	1,601	2,820	2,484
1964	15,471	1,026	3,729	4,248	2,107	1,688	2,725	2,136
Latest	13,734	1,124	4,604	4,404	2,403	1,756	2,660	2,226
Change	−10,829	+628	+4,081	+4,404	+2,147	+1,561	+1,156	+538

Answer: In the market, one learns to go with trends. The attached chart shows one of the strongest trends existent in the world of finance today. It portrays the trend of leading foreign central banks to boost their holdings of gold even while the U.S. inflates and loses its gold. Study this chart. Note the trend over the past few years. Do these nations appear ready to follow the U.S. example? Are they building up huge piles of non-interest bearing gold bars by mistake? The writing is on the wall. They are not interested either in building up their supply of dollars or in accepting any new U.S. "gold-free" "composite currency" plans. Asking France or Holland to go off gold would be like asking a rich man to share the wealth. Share it, he's worked his whole life to get it!

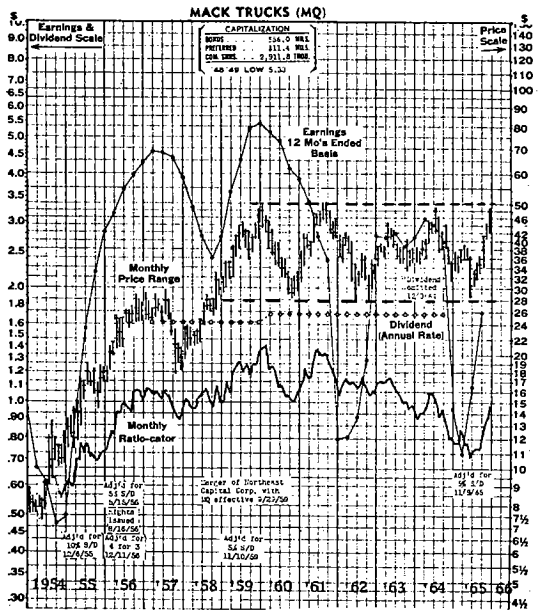
CHARTS OF THE WEEK: Here are two chart pictures that, as the old saying goes, are worth a thousand words. The "conversion" price of gold is around 9¢; this is the cost of shipping gold from one port to another. Whenever gold is above $35.09, it is obviously above the price which central banks would have to pay if they shipped it from the U.S. to Europe. Presumably, the gold pool is losing gold whenever the price of gold is above the conversion price. As seen on the accompanying chart, the price of gold has been above conversion ever since mid-1964, and at present the price appears to be in its third major upward movement.



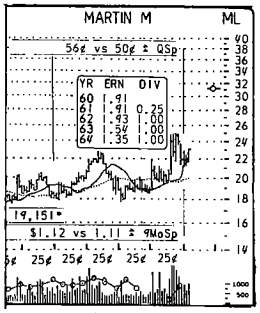


Last week was a dramatic one for students of the money market. The drama becomes immediately apparent as one glances at the Treasury bill yield chart. As in all bull markets (and we are now in a bull market of interest rates), one thing leads to another. A day after the all-time high in bill yields, President Johnson announced that the rate on U. S. Savings Bonds was inadequate and would have to be raised (Jan. 18). Interesting aside: one large N.Y. savings bank which was slow in raising its interest rate from $4\frac{1}{4}$ to $4\frac{1}{2}$% stated that it had lost $10 million in deposits in two weeks. It raised its rate!

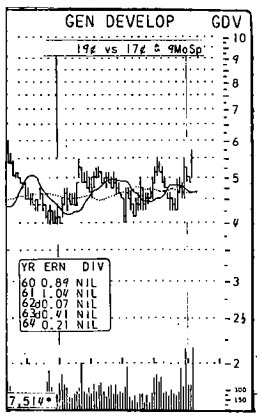
STOCKS: The last Letter discussed the wisdom of buying Mack Trucks if the stock succeeds in pushing out of an immense "rectangle" formed by the movements of MQ over the past 10 years. The wrong side of the chart was mistakenly shown (Lorillard), so as a special bonus to long-suffering subscribers I am herewith presenting the correct chart. As of this writing, MQ has not been able to better the top limit of the rectangle, and I would refrain from purchases unless MQ shows signs of being able to do so.


MACK TRUCKS (MQ)
Earnings & Dividend Scale
Price Scale
Earnings 12 Mo's Ended Basis
Monthly Price Range
Dividend (Annual Rate)
Monthly Ratio-cator
1954 55 56 57 58 59 60 61 62 63 64 65 66

Also of interest at this time is Aluminum Co. of America (AA). Its two-year trend of relative strength has finally reversed to the upside. Furthermore, AA has been the recipient of consistently heavy odd-lot selling during its entire recent rise. This would suggest that as AA approaches its 1964 high, the little holder (who has been waiting for years to get out even) is finally selling out, and he is selling out to the large (i.e., the even lot) trader.



Martin and Gen. Development, two recent speculative choices, are both performing well in this market (see weekly charts).



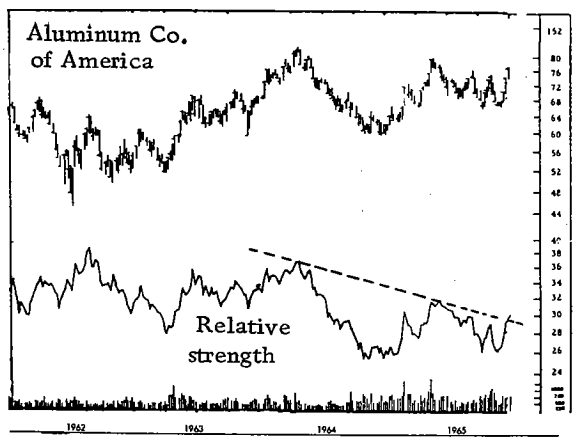


Chart of Mack courtesy of Securities Research Corp., 211 Congress St., Boston, Mass. 02110.
Chart of AA courtesy of Traders Research, 1431 Pearl St., Alton, Illinois 62003.
Small weekly charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.